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INFO AMEMBASSY MADRID IMMEDIATE

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PASS: CEA, TREAS, FRB

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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF SPAIN

REF: EDP(77)13

1. SUMMARY: IN REFDOC CIRCULATED (LATE AND ONLY IN FRENCH) FOR MAY 24 EDRC REVIEW OF SPAIN, SECRETARIAT NOTES THAT ECONOMIC ACTIVITY PICKED UP EARLY IN 1976, BUT WAS ACCOMPANIED BY RAPID INFLATION, LARGE (AND PROBABLY UNSUSTAINABLE) CURRENT ACCOUNT DEFICIT AND DETERIORATION IN LABOR MARKET SITUATION. MOREOVER, SECRETARIAT FEELS THAT LITTLE IMPROVEMENT CAN BE EXPECTED IN ANY OF THESE AREAS IN 1977, AND CALLS FOR MEASURES TO REVERSE DOWNWARD SPIRAL OF SPANISH ECONOMIC PERFORMANCE. FOR SHORT TERM, SECRETARIAT RECOMMENDS MORE RESTRICTIVE MONETARY POLICY THAN CURRENTLY PLANNED BY GOS AND CAUTIOUS INCREASE OF LIMITED OFFICIAL USE

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EMPLOYMENT-CREATING PUBLIC INVESTMENT TOGETHER WITH REDUCTION OF CURRENT BUDGET DEFICIT. SECRETARIAT ALSO URGES GOS TO ADOPT MORE FLEXIBLE EXCHANGE RATE POLICY. SECRETARIAT ANALYZES FUNDAMENTAL TRENDS IN SPANISH ECONOMY BETWEEN 1960 AND 1974 AND FORMS JUDGEMENTS AS TO MAJOR CAUSES OF STRUCTURAL IMBALANCES WHICH HAVE DEVELOPED DURING THAT PERIOD. SECRETARIAT THUS URGES GOS TO (A) GRADU-

ALLY REDUCE DEGREE OF PROTECTION OF DOMESTIC INDUSTRIES;
(B) IMPLEMENT MORE FLEXIBLE INTEREST RATE POLICY (AND IN
GENERAL ALLOW MARKET FORCES GREATER PLAY); AND, (C) TAKE
STEPS TO IMPROVE INCOME DISTRIBUTION TO SET STAGE FOR
DEVELOPMENT OF SOCIAL CONSENSUS ON APPROPRIATE GROWTH OF
WAGES AND PRICES. ACTION REQUESTED: MISSION WOULD APPRE-
CIATE COMMENTS/QUESTIONS WHICH COULD USEFULLY BE POSED AT
REVIEW. (NOTE; REP FROM EMBASSY MADRID WILL PARTICIPATE
IN REVIEW.) END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: SECRETARIAT
NOTES THAT AFTER SLOWDOWN IN ECONOMIC ACTIVITY IN FIRST
QUARTER OF 1976, RECOVERY BEGAN ANEW. RECOVERY WAS ESSEN-
Tially EXPORT LED, ALTHOUGH PRIVATE CONSUMPTION, SPURRED
BY DECLINE IN SAVINGS RATE, LENT HELPING HAND AS WELL.
IN CONTRAST, GROSS FIXED CAPITAL FORMATION DECLINED BY
2 PERCENT AND PRODUCTIVE INVESTMENT PROBABLY DECLINED
EVEN MORE. REACCELERATION OF PRIVATE INVESTMENT SPENDING
AT END OF 1976 WAS DUE, IN SECRETARIAT VIEW, TO RELAXA-
TION OF MONETARY POLICY AND TO IMPROVEMENT IN FIRMS'
PROFIT MARGINS DURING YEAR. WHILE NOTING DIFFICULTY OF
INTERPRETING SPANISH LABOR MARKET STATISTICS, SECRETARIAT
INDICATES THAT SITUATION IN LABOR MARKET PROBABLY DETERI-
ORATED SERIOUSLY LAST YEAR. SECRETARIAT ESTIMATES THAT
UNEMPLOYMENT ROSE FROM 3.5 PERCENT IN 1975 TO 4.9 PERCENT
IN 1976.

3. PRICES: DESPITE WEAKNESS OF FINAL DEMAND, INFLATION
RATE ACCELERATED IN 1976 AS CONSUMER PRICES ROSE AT AVER-
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AGE ANNUAL RATE OF 17.8 PERCENT (INCREASE DURING YEAR WAS
20 PERCENT). SECRETARIAT LAYS BLAME ON SHARP RISE IN
FOOD PRICES, ACCELERATION OF WAGE INCREASES, DEPRECIATION
OF PESETA AND SOME RECONSTITUTION OF PROFIT MARGINS AT
RETAIL LEVEL.

4. DOMESTIC OUTLOOK FOR 1977: SECRETARIAT CITES GOS
FORECASTS FOR 1977: 2.6 PERCENT RISE IN PRIVATE CONSUMP-
TION; 4.5 PERCENT INCREASE IN PUBLIC CONSUMPTION; 3 PER-
CENT GROWTH OF TOTAL INVESTMENT; AND 3.5 PERCENT RISE IN
REAL GDP. SECRETARIAT CONSIDERS GOS PROJECTIONS SOMEWHAT
OPTIMISTIC; IT FORECASTS 1.5 PERCENT GROWTH OF PRIVATE
CONSUMPTION AND STAGNATION OF PRODUCTIVE INVESTMENT AT
END-1976 LEVEL. IN ADDITION, SECRETARIAT FORESEES 20
PERCENT RISE IN PRICES DURING 1977 AND FURTHER INCREASE
IN UNEMPLOYMENT.

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5. CURRENT ACCOUNT: SPAIN RECORDED CURRENT ACCOUNT DEFICIT OF \$4.4 MILLION IN 1976. DEFICIT WAS FINANCED PRIMARILY BY PUBLIC SECTOR BORROWING, OTHER "COMPENSATORY" BORROWING AND \$1 BILLION RUNDOWN OF RESERVES. TOTAL EXTERNAL DEBT WAS \$11 BILLION AT END OF 1976. FOR 1977, SECRETARIAT FORECASTS 8 PERCENT INCREASE IN EXPORT (GOODS AND SERVICES), AND MINIMAL INCREASE IN IMPORT VOLUMES, BUT REDUCTION OF ONLY \$500 MILLION IN CURRENT ACCOUNT DEFICIT. SECRETARIAT WARNS THAT ACCUMULATION OF EXTERNAL DEBT AT CURRENT RATE CANNOT CONTINUE FOR LONG.

6. FISCAL AND MONETARY POLICY: SECRETARIAT NOTES THAT MONETARY POLICY BEGAN 1976 IN RESTRICTIVE POSTURE BUT WAS RELAXED DURING YEAR. FISCAL POLICY FOLLOWED OPPOSITE PATTERN. SECRETARIAT STATES THAT ADDITIONAL STIMULATORY FISCAL MEASURES ANNOUNCED IN FEBRUARY, 1977 WILL HAVE LITTLE EFFECT THIS YEAR AND FEELS THAT IMPACT OF FISCAL

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POLICY WILL BE NEUTRAL IN 1977. GOS HAS SET TARGET FOR GROWTH OF MONEY SUPPLY (M3) AT 21 PERCENT FOR 1977.

7. SECRETARIAT REVIEWS DEVELOPMENTS IN SPANISH ECONOMY FROM 1960 TO 1974 AND IDENTIFIES SOME UNDERLYING CAUSES OF SIGNIFICANT DISEQUILIBRIUM WHICH PRESENTLY EXIST. THESE CAUSES INCLUDE: (A) EXCESSIVE CAPITAL INTENSITY, FOSTERED BY ARTIFICIALLY LOW INTEREST RATES, AND RESULTING IN SLOW GROWTH OF EMPLOYMENT; (B) POLICY OF PROTECTING DOMESTIC INDUSTRIES; AND, (C) POLITICAL/SOCIAL SYSTEM WHICH HAS PRECLUDED FORMATION OF CONSENSUS ON APPROPRIATE GROWTH OF PRICES AND INCOMES.

8. MAIN CONCLUSIONS: BASED ON ANALYSIS REFDON, SECRETARIAT SUGGESTS THAT EDRC REACH FOLLOWING MAIN CONCLUSIONS:

(A) GOS SHOULD ACT AT ONCE TO BRING INFLATION DOWN BY REDUCING OFFICIAL TARGET FOR GROWTH OF MONEY SUPPLY IN 1977;

(B) FISCAL POLICY SHOULD MOVE CAUTIOUSLY TO INCREASE EMPLOYMENT - CREATING PUBLIC INVESTMENT AND TO ALLEVIATE SOCIAL BURDEN OF RISING UNEMPLOYMENT;

(C) MEASURES TO ELIMINATE STRUCTURAL IMBALANCES IN SPANISH ECONOMY OF MEDIUM TERM ALSO NECESSARY INCLUDING:

(I) ADOPTION OF MORE FLEXIBLE INTEREST RATE AND EXCHANGE RATE POLICY; (II) GRADUAL MOVE AWAY FROM PROTECTIONISM; (III) IMPROVEMENT OF INCOME DISTRIBUTION TO FACILITATE FORMATION OF SOCIAL CONSENSUS ON PRICES AND INCOMES.

9. COMMENT: (A) SECRETARIAT FORECASTS 8 PERCENT RISE IN SPANISH VOLUME OF EXPORTS OF GOODS AND SERVICES IN 1977 AND NOTES THAT SPANISH MARKETS SHOULD GROW BY SAME AMOUNT. HOWEVER, SECRETARIAT ALSO FORECASTS 20 PERCENT LIMITED OFFICIAL USE

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RISE IN INFLATION RATE AND ADOPTS USUAL ASSUMPTION OF CONSTANT EFFECTIVE EXCHANGE RATE OVER FORECAST PERIOD. ASSUMING SECRETARIAT'S INFLATION FORECASTS AND EXCHANGE RATE ASSUMPTIONS ARE ACTUALLY REALIZED, IT IS LIKELY, IN MISSION VIEW, THAT SPANISH WILL LOSE MARKET SHARES IN 1977. (NOTE: GOS FORECASTS 6.5 PERCENT GROWTH IN

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VOLUME OF GOODS/SERVICES EXPORTS.) MISSION WOULD QUESTION SECRETARIAT AND SPANISH DEL ON THIS POINT; (B) GOS MONETARY POLICY SEEMS TO HAVE FOLLOWED COURSE OF PURE ACCOMMODATION IN 1976. TARGETS FOR GROWTH OF M3 WERE RAISED IN LINE WITH UPWARD REVISION OF PRICE FORECASTS. SIMILARLY, GOS PLANS GROWTH OF M3 IN 1977 ROUGHLY EQUAL TO THAT OF NOMINAL GDP. MISSION WOULD SUPPORT SECRETARIAT'S RECOMMENDATION THAT SPANISH MONETARY POLICY BEGIN LEANING AGAINST WIND. MISSION WOULD ALSO AGREE THAT MORE FLEXIBLE INTEREST RATE POLICY COULD IMPROVE GOS CONTROL OVER MONEY SUPPLY AND WOULD HELP REMOVE INAPPROPRIATE SUBSIDY TO CAPITAL FORMATION; (C) MISSION WOULD SOLICIT SPANISH VIEWS ON LIKELY DEVELOPMENT OF CURRENT ACCOUNT AND ITS FINANCING IN SHORT AND MEDIUM TERM. MISSION WOULD ALSO ASK SPANISH TO INDICATE WHETHER MATURITY STRUCTURE OF EXISTING EXTERNAL DEBT IMPLIES IMPORTANT "LUMPS" IN REPAYMENT SCHEDULE; (D) MISSION WOULD SUPPORT SECRETARIAT CALL FOR MORE FLEXIBLE EXCHANGE RATE POLICY

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AND WOULD NOTE THAT THIS WOULD CONSTITUTE RELATIVELY MORE EFFICIENT SUBSTITUTE FOR PLETHORA OF EXPORT-STIMULATION SCHEMES AND IMPORT CONTROLS AND DUTIES NOW

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